

EFFECTS OF INTERNATIONAL FINANCIAL CRISIS ON THE FINANCIAL SYSTEM AND MONETARY POLICY

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Abstract

The current financial and economic crisis seems to be unprecedentedly in the last half century. The economic downturn extended in the USA, Europe and Japan seems to be much more painful than the economic downturn in 1981-1982. A massive drop of confidence is under way, both across the business sector, and the consumers, both reacting by cutting costs. The U.S. Government and some governments in Europe, are trying to recover stability, and nationalized parts of their financial sectors to an extent that is in conflict with the modern capitalism basics. Today the entire world seems to change its direction, shaping its course to a period wherein the state role will be higher, and that of the private sector will be lower. This will be probably the most dramatic consequence of the current economic crisis.

Keywords: liquidity, inflation, financial-accounting reportings, fiscal policy, financial markets

JEL Classification: E30, E50, E60.

1. Introduction

Many people consider the current financial crisis originates in the dramatic drop of housing price in the USA or in falling the credit market for housings. This vision is at least incomplete. The basic reasons of the financial crisis are deeper, both macroeconomic and microeconomic, issue recently mentioned by several analysts: Altman (2009), Buiters (2008), Blanchard (2009). The two types of reasons have interconditioned in causing the crisis. I will refer in turn to both types of reasons.

The profound reason of the financial crisis was the high liquidity created by the main world central banks (FED, BOJ) and by the desire of the oil and gas exporting countries to restrict the currency appreciation. Also, there was a satiation with savings, generated by the increasing integration of some countries in the global economy (South-East Asia in general), with high accumulation rates, and by the global redistribution of wealth and income to the strong asset exporters (oil, natural gas etc.). High liquidity and satiation with savings created available resources for investment, including in sophisticated financial tools, not easy to understand by some investors.

The consequences of high liquidity have been the very low interest rates and

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their low volatility. Together, these consequences have led to rising the appetite for high income assets. Moreover, the low volatility on the market has created the trend of risk underestimation and a real lack of vigilance from investors. The risk margins have also been very low and non-discriminatory. Together, the low interest rates, the appetite for high income assets, the low vigilance to risk and the low margins hampered the warnings of prices on the financial markets and led to an incomplete understanding of the involved risks.

Under these circumstances a series of microeconomic reasons has also worked as aggravating: cracks in the business model of the rating agencies, privately rational outsourcing but socially ineffective and, finally, an increased international competition for deregulations.

Establishment of investors' distrust has placed rapidly the bonds issued by the special purpose vehicles (SPV) in the risky category (quality of assets financed was not clear any longer) and refinances became impossible. Due to discrepancy between maturities on assets and liabilities, these SPV have started relying on financing from sponsoring banks. Finally, the liquidity demand, in conjunction with the loss of confidence in banks, drove the rush after cash and the effective interest rate has started rising.

In the USA and some states in Europe, governments and central banks responded by improving liquidity; granting of governmental warranties for loans; recapitalization of financial institutions; warranty of the newest issuance to insured banks; prevention of erratic collapse of major interconnected enterprises; purchase of stocks in banks; coordinated reductions of interest rates. Although such kind of measures have been implemented, after 17 months from starting the turbulences, the market remained non-transparent, and hence financial crisis increased and shifted to the real sector of economy, first in the USA, then in other developed countries.

In the short term the main challenge consists in finding solutions to recover the investors' and consumers' confidence. In the long term, the main challenge consists in adjusting the principles that guide the reform of the foreign financial system, chiefly related to transparency, improvement of regulations concerning safekeeping account bookkeeping, assurance of a suitable regulation of markets, firms and financial products, assurance of financial market integrity (concerning market handling and fraud), and strenghtening of cooperation between the world financial institutions (modernization of the governance structures of the IMF and the World Bank). The business ethics is not missing in this list of future challenges.

2. Financial crisis and Romania's economy

The effects of international financial crisis have also extended on Romania's economy. However, as regards the direct impact, the banking system has been scarcely affected as it has not been exposed to harmful assets, as well as thanks to the prudential and administrative measures adopted in the course of time by the National Bank of Romania. But indirectly, the international financial crisis and especially its obvious consequence – economic downturn in the developed countries – extend

over Romanian economy on several directions. As regards the commercial direction, it slows or even reduces the increase in exports. As regards the financial direction, it restricts the access to foreign financing, and thus curtails the amount of lending, and generates difficulties in the service of private external debt. As regards the exchange rate, reduction of external financing reflected in the depreciation of local currency. As regards the confidence direction, investors have retreated from the Eastern European countries. As a result, some moments of panic and speculative attacks took place on the monetary-money market like that in October in Romania that required the National Bank's support. Finally, as regards the direction of wealth and balance effect, the damage of population and companies' net asset occurs, as a result of high weight of foreign currency credits (correlated with the leu depreciation) and decline in prices of personal assets and property from speculative values, non-sustainable (*"bubble"* type).

Spreading of these effects makes the extent of uncertainty concerning the evolutions of economic variables be extremely high. In its turn it results in deepening the crisis by means of negative effects it has on expectations and by augmentation of the extent of caution with consumers and companies. In Romania, the feedback to the adverse effects of crisis cannot be similar to that stated by some European states or that in the USA. There are some differences between the Romanian economy and these economies, that do not enable simply the copy of the measure package developed there. Basically, it is about the fact that Romanian economy has a high current account deficit, indicating its dependance on foreign financing. We have to choose between the ordinate reduction of this deficit or its reduction by the market in the current circumstances of strain and distrust, with dramatic consequences on exchange rate and economic growth.

Although the progress of the economic adjustment process cannot be planned accurately, however, promotion of some coherent and credible economic policies could avoid occurrence of an orderless adjustment (hard landing). Therefore, the government should avoid an emotional approach of crisis under pressure of labour unions and patronizing federations, that would result in the adoption of some stimulation measures of domestic demand, making difficult to bring the current account deficit to a sustainable level. If the macroeconomic policies combination is focused only on the adjustment process of external imbalance (current account deficit) and the domestic one (budget deficit) can result in sustaining a smooth landing of the economy and improvement of foreign investors' perception.

Basically, a significant strengthening of the fiscal policy and wage policy is required (widely, comprising increments and cvasi wage bonuses). To this effect, the budget for 2010, approved recently, is a praiseworthy first step, especially thanks to the assignment of some relatively high funds for investments having the potential to create "spillover effects" over the other economic sectors. The possibility of a gradual easing of monetary policy will occur as it is put into practice. Therefore, a suboptimum combination existing in the past years (slack fiscal and wage policies, a "very tight" monetary policy respectively) could be replaced with an optimum

combination wherein all policies (budgetary, wage and monetary) have a similar restrictive nature and guide economic activity to work and productivity.

In addition, the government may contribute to the improvement of foreign investors' perception by means of measures such as improvement of the absorption ability of European funds and thus replacement of private financing with public external financing to a certain extent, or by creating new jobs in insufficiently developed fields (infrastructure, tourism, agroalimentary), that should gradually become the drive force of economic growth. Generally speaking, the settlement of some financing agreements with world organizations, starting with the European Commission and the European Investment Bank, to balance the slight reduction of private capital inflows is welcome. If all these steps will be followed, it is very likely that investors improve their perception about Romania and prefer investing here than in other Central or Eastern European countries. However, the high probability does not amount to certainty: one cannot reject the scenario wherein Romanian authorities do their best, so as foreign investors react positively and make no difference between Romania and its neighbours. However, the awareness regarding this possibility should not lead to defeatism and resignation of the so necessary adjustment measures.

3. Targeting inflation and financial crisis

Hereinafter I shall refer to the monetary policy strategy of the National Bank of Romania– targeting inflation – in close connection with the current financial crisis and with the problems our contry is confronting with.

The option for adopting targeting inflation as a monetary policy strategy has been justified by the need of reaching a sustainable desinflation. Implementation of the inflation targeting strategy was not easy before the occurence of financial crisis and fiscal dominance, massive capital inflows, net debtor position of the National Bank of Romania in regard to the banking system and mechanism of rendering the monetary policy have combined, thus, between 2005 and 2007, there were periods of time when inflationary anticipations and currency marked estimations coexisted. This arose a severe dilemma for the Central Bank. Increases of interest rate required to bring anticipations in line with the inflation target were attracting even more foreign money, appreciating the leu non sustainably.

At the same time with starting the financial crisis in July 2007, some of these circumstances dissapeared. Today the National Bank of Romania tends to be a net creditor of the banking system, and foreign capital inflows have diminished significantly. But it does not simplify the implementation of monetary policy. On the contrary, financial crisis has increased volatility on the monetary and foreign exchange markets and tends to increase the slackening of economic activity. On the one hand, reduction of foreign finances and existance of significant foreign imbalances have triggered the leu depreciation, that fuels inflation and makes necessary a relatively high interest rate. Moreover, those with debts expressed in

Euros and other currencies, and therefore the financial system, are vulnerable to a significant leu depreciation. On the other hand, higher interest rates would tend to hamper economic growth and, furthermore, would create costs for those with debts, risking to destabilize the financial sector. Under these circumstances it occurs the delicate issue of the compromise between the monetary policy objectives: assurance of price stability and assurance of financial stability.

Friedman (1968) and Phelps (1968) have showed there is not compromise between inflation and unemployment in the long term. Hence it results the objective of the monetary policy in the long term should be the accomplishment of a low and steady inflation. It has been noticed the low and steady inflation helps the sustainable economic growth in the long term. Consequently the low and steady inflation is both a purpose itself, and a means of accomplishing a sustainable economic growth (Bernanke, 2006).

However, the efficiency of monetary policy in reaching this purpose is limited if there is not financial stability. One of the main macroeconomic principles states that financial frictions substantially affects the business cycle. Today, this issue is obvious worldwide. The world central banks are trying to keep financial stability and avoid economic downturn.

The previous experiences seem to confirm the vision wherein inflation is the main source of financial instability. As usual, the periods of time characterized by high inflation have been those with severe financial instability and crisis across the banking sector or have been followed by downturn as the authorities adopted some unsuitable measures of reducing inflation.

However, the recent economic literature emphasizes that a low inflation is not an adequate requirement to secure financial stability in the long term (Crockett, 2003). In modern economies, a low and steady inflation has led to the creation of a new economic climate, requiring the accurate reconsideration of the relationship between price stability and financial stability. Therefore, a new battle front has opened, dedicated to fighting against financial instability. To this effect, experience of some Asian countries in 1997-1998 and the current economic and financial crisis drive the reconsideration of the measure wherein the central bank is able to secure price stability and financial stability simultaneously assuming their accomplishment requires the adoption of some conflicting measures.

Romania's experience shows that financial stability has a major importance for stability of prices. With good reason, Romania has been criticised for delays in desinflation. These delays have been caused by deficient structural reforms. Our country reached an average desinflation rate of 5.8 percentage points a year in 2000-2007, in parallel with maintaining the stability of the financial system. But if the National Bank of Romania would have balanced this lack of reforms by means of steeper increases of the interest rate the financial situation of firms and households would have worsened. Therefore financial stability of the banking sector would have worsened. Finally, the desinflation pace itself would have been probably lower than that accomplished. The lesson that should be learned is that, in the long term,

incapability of maintaining financial stability only leads to a rise of inflation.

By adopting targeting inflation it has opted to make as much place as possible to market in setting the exchange rate. However, there were cases when the leu fluctuations were by far out of the limits justified by the exchange rate basics. That was the case several times in 2004-2007, when massive capital inflows occurred and the leu appreciated largely. It happened so in some periods of time, even after the current foreign financial crisis started, including in 2009. These were the reasons for which a managed floating of the exchange rate. It does not mean one may interfere on the foreign currency market in a discretionary way.

The policy of the National Bank concerning its supports on the foreign currency market has been guided by the philosophy according to which a high volatility exchange rate is harmful for both inflation concerning objective, and financial health of the real sector and the financial sector. With this philosophy, the National Bank of Romania has promoted a floating exchange rate, that enabled it to use both the free market opportunities and discourage speculative behaviours, and to avoid outrageous appreciations.

The consistent implementation of this philosophy required relatively important foreign currency purchases from the market by the National Bank of Romania in 2004 – August 2007. When the foreign currency was purchased, the National Bank of Romania was criticised as it did not allow the exchange rate to appreciate in line with the market requirements. Today it is a fact this policy was suitable. The current financial crisis has introduced a steep inversion of the leu appreciation trend, with important episodes of volatility. As the case stands, in the past, the foreign currency inflows have appreciated the leu much more than the level indicated by the basic factors of the exchange rate, nowadays reduction of foreign financing and uncertainty tend to cause leu depreciations not justified by the basic factors of the exchange rate. Today the reserves purchased on the foreign currency market in the moments of superappreciation serve for supports required to ease the leu depreciation.

The National Bank of Romania is sending the market a message concerning annealing of the political situation and confidence regarding continuation of the disinflation process in 2010 and stability of exchange rate, that highlights the importance of correlating the market interests with the key interest. The Managing Board of the National Bank has decided to lower the monetary policy interest from 8% to 7.5%, level that has not been reached for 2 years, by means of a surprise-measure for the market, as most analysts were anticipating the interest rate remained at the same level or it decreased by a quarter of a percentage point, to 7.75%.

The message sent by means of the central bank's decision is an optimistic one. The National Bank of Romania is confident that we shall realign with the provisions of the agreement with the International Monetary Fund and the European Commission, i.e. most uncertainties vanished. Moreover, the National Bank of Romania does not see depreciation pressures exerted on the exchange rate and in the very short term, there are inflationary pressures occurred as a result of increasing

excise, but the National Bank of Romania considers the inflation will continue to diminish.

Except January, when inflation will be higher, the disinflation process will likely restart in February and we shall probably see annual inflation rates less than 4% in the first part of 2010.

In the meeting dated 5th of January 2010, the Managing Board of the National Bank of Romania (BNR) decided the following: reduction of the monetary policy interest rate to 7.5% a year from 8% a year, starting from the date of 6th January 2010, the adamant management of liquidity in the banking system in order to strengthen transmission of monetary policy signals and maintaining the current levels of the compulsory minimum reserves rates applicable to the liability in lei or in foreign currency of lending institutions.

In 2009, the central bank diminished the key interest by five times, from 10.25% to 8%, and lowered the minimum compulsory reserves required to commercial banks to 15% from the reduction of compulsory minimum reserves was made within a surprise-meeting of the National Bank, in the mid-November 2009, when the Managing Board decided to reduce them from 30% to 25% for the banks' foreign currency liabilities, as a result of delaying the third tranche of Romania's foreign loan from the International Monetary Fund, that had to be delivered last December.

4. Role of accounting within the current financial crisis

Financial crisis hallmarked on economies all over the world, that experienced the economic recession: the GDP of some countries with a very developed economy has registered major declines, exports have reduced significantly, damage of estate markets has exacerbated, car markets have declined, the deflation risk has increased, unemployment has gone up significantly, and countries of the third world have started receiving less aids, resulting in worsening poverty and famine. The sweeping bankruptcies continue to occur, many specialists consider that one cannot talk about a way out from the crisis.

As regards the increasingly significant economic effects of financial crisis and as some saving plans are increasingly expensive for common people, there were opinions that tried identifying the causes for these events and those responsible for the current crisis. Opinions were different, but many specialists agreed that one of the factors that generated the current events has been the unsuitable use of some complex financial tools that became impossible to understand even for their creators. The consequences of their use consisted in increasing the opacity of the financial system and financial reportings, accused of hiding the existing risks and, as a result, distorting the information sent to the interested public.

Perception on a close connection between crisis and certain types of financial tools has led to discussing prevalently about *accounting standards* concerning these tools. The topic became hot in mass media, the accounting standards being mainly considered responsible for the fair value related rules. The bankers and insurers

have put the blame on them as being responsible for some huge losses registered by financial institutions related to financial tools whose markets became non-liquid, losses accounted as a result of some effective transactions that worsened a situation already poor.

Other opinions thought that for the current crisis the accounting rules are not responsible but financial reportings related to financial tools, fair value and risks, that were short of transparency and comparability because of an unsuitable application of the information description norms. The main reason of critics consisted in the fact that financial reportings should have provided a clearer and more desirable picture of the risks involved by using some sophisticated financial tools, in order to enable the investors and other interested parties to evaluate the companies' assets, debts and equity capitals correctly.

The role of fair value accounting and financial-accounting reportings within the current crisis can be evaluated by surveying and commenting the information published through financial statements carried out by the American and European financial institutions, as it is known that financial sector is one of the most affected by the current events.

Studies carried out by various bodies, the Securities and Exchanges Commission in the USA, the Merrill Lynch Study, the Council for Financial Accounting Standards and others respectively have surveyed the impact of fair value accounting on financial institutions.

The Report of the Securities and Exchanges Commission is focused on surveying the weight of assets and debts evaluated at fair value in total assets and debts, effects of fair value fluctuations over the revenue account, using the fair value by financial institutions in compliance with their wish, the nature of assets and debts evaluated at fair value. The Merrill Lynch Study has taken into consideration the recent bank crashes and losses or significant profit reductions in the field, identifying the main causes of these evolutions and the Council for Financial Accounting Standards has surveyed the institutions that did not survived the crisis and went forward comparing the market value of some important commercial banks with that resulted in account books.

Following the survey of this studies, the conclusion was that the fair value accounting was the main cause of triggering the current crisis. This has not played a major role either in far-reaching bankruptcies of some American financial institutions, rather caused by significant losses registered at credits granted very easily, the unsuitable risk management policy, financial engineering were out of hand and the lack of some appropriate prudential regulations.

The specialists drew a set of conclusions related to the role of accounting within the current financial crisis:

- ✓ Accounting rules, especially those related to fair value cannot be considered responsible for triggering and spreading the crisis, for which more profound causes have been identified.

- ✓ The role of accounting does not consist in securing financial stability, but in

providing useful information to users interested in decision-making, even if they put the managers in a tight corner. Therefore, the accounting should not be used as means of reaching stability, as it could affect its transparency, and it cannot be a working tool against the pro- cycle, as it should remain neutral.

✓ The fair value accounting should not be eliminated or suspended, not even in situations of crisis, as investors consider it the best method to evaluate financial tools, that can be improved by means of guides and further recommendations, hereupon the normalizing bodies are working to.

In connection with financial reportings it can be stated that:

✓ Information shown is extremely complex, and hence it does not help at all the restoration of investors' confidence in financial markets, confidence strongly shaken by the current crisis.

✓ In order to reach the required transparency and comparability, only implementation of the accounting standards is not enough, information presented should be detailed and explained accordingly.

✓ The accounting normalizing bodies are required to improve the reporting requirements.

5. Conclusions

In this period of turbulences and uncertainties I think the Euro Adoption Program will be the best guide. Romania should keep its calendar announced previously for Euro adoption, on condition that entering the ERM-II exchange rate mechanism on the 1 st of January 2012 and running the compulsory minimum period of two years within this mechanism is imposed by the requirement that many suitable and efficient reforms should be carried out in Romania, up to 2012.

Under the current economic circumstances, companies start providing a higher attention to the efficient management of resources and use to this end the income and expenditure budget – as a financial management tool, within the firm and within the main types of the firm's activities. The basic component of the control record, having direct connections with the planning structures, observation-control and accounting the entire activity, the budget is an important planning tool in the short term. It is considered the accounting and financial expression of the action plans retained to be applied, for which the targeted objectives and means available in the short term converge to the accomplishment of the operational plans.

If until now most markets in Romania have been „seller markets”, wherein producers and merchants had not to apply sophisticated strategies to stimulate sales, today companies should revise their strategy in order to „sail” on the economic and financial crisis successfully.

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